

ASSEMBLY BILL

No. 571

Introduced by Assembly Member Hagman

February 16, 2011

An act to amend Sections 500, 506, and 509 of, to repeal Sections 502 and 507 of, and to repeal and add Section 503 of, the Corporations Code, relating to corporations.

LEGISLATIVE COUNSEL'S DIGEST

AB 571, as introduced, Hagman. Corporations: distributions.

Existing law provides for the formation and governance of corporations. Existing law allows a corporation to make a distribution of cash or property to shareholders, including a dividend or a repurchase or redemption of shares, only if either the corporation has retained earnings prior to the distribution equal to or exceeding the amount of the distribution or the corporation can satisfy specified balance sheet test and liquidity requirements after giving effect to the distribution, and the distribution will not render the corporation insolvent.

This bill would allow a corporation to distribute cash or property to shareholders, including a dividend or repurchase or redemption of shares, if the amount of the corporation's retained earnings prior to the distribution equals or exceeds the sum of the distribution and the cumulative dividends in arrears on certain preferred stock and, after giving effect to the distribution, the value of the corporation's assets equals or exceeds the sum of its liabilities and the liquidation preference of any preferred stock, except as specified. The bill would provide that a board of directors may base a determination that the value of its assets exceeds the amount of liabilities on financial statements prepared on the basis of accounting practices and principles that are reasonable in

the circumstances, a fair valuation, or any other method that is reasonable under the circumstances.

Existing law provides that a shareholder who knowingly receives an improper distribution is liable to the corporation's creditors and holders of preferred shares, as specified, and that those parties may bring suit in the name of the corporation to enforce those liabilities.

This bill would provide that holders of shares having preferential rights with respect to cumulative dividends in arrears shall not have the right to bring suit with respect to an improper distribution unless the amounts owed those holders, as specified, is greater than zero. The bill would also provide that a cause of action with respect to an obligation to return an improper distribution shall be extinguished unless brought within 4 years of the distribution date.

Existing law requires a corporation to provide notice, as specified, to shareholders, with respect to a dividend other than one chargeable to retained earnings, stating that the dividend is being made from a source other than retained earnings, and stating the accounting treatment of the dividend.

This bill would eliminate that requirement.

Vote: majority. Appropriation: no. Fiscal committee: no.
State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. Section 500 of the Corporations Code is amended
2 to read:
3 500. (a) Neither a corporation nor any of its subsidiaries shall
4 make any distribution to the corporation's shareholders (Section
5 166) ~~except as follows unless the board of directors has determined~~
6 ~~in good faith either of the following:~~
7 ~~(a) The distribution may be made if the~~
8 ~~(1) The amount of the retained earnings of the corporation~~
9 ~~immediately prior thereto to the distribution equals or exceeds the~~
10 ~~sum of (A) the amount of the proposed distribution plus (B) the~~
11 ~~preferential dividends arrears amount.~~
12 ~~(b) The distribution may be made if immediately after giving~~
13 ~~effect thereto:~~
14 ~~(1) The sum of the assets of the corporation (exclusive of~~
15 ~~goodwill, capitalized research and development expenses and~~
16 ~~deferred charges) would be at least equal to $1\frac{3}{4}$ times its liabilities~~

1 (not including deferred taxes, deferred income and other deferred
2 credits); and

3 (2) ~~The current assets of the corporation would be at least equal~~
4 ~~to its current liabilities or, if the average of the earnings of the~~
5 ~~corporation before taxes on income and before interest expense~~
6 ~~for the two preceding fiscal years was less than the average of the~~
7 ~~interest expense of the corporation for those fiscal years, at least~~
8 ~~equal to 1 ¼ times its current liabilities; provided, however, that~~
9 ~~in determining the amount of the assets of the corporation profits~~
10 ~~derived from an exchange of assets shall not be included unless~~
11 ~~the assets received are currently realizable in cash; and provided,~~
12 ~~further, that for the purpose of this subdivision “current assets”~~
13 ~~may include net amounts which the board has determined in good~~
14 ~~faith may reasonably be expected to be received from customers~~
15 ~~during the 12-month period used in calculating current liabilities~~
16 ~~pursuant to existing contractual relationships obligating those~~
17 ~~customers to make fixed or periodic payments during the term of~~
18 ~~the contract or, in the case of public utilities, pursuant to service~~
19 ~~connections with customers, after in each case giving effect to~~
20 ~~future costs not then included in current liabilities but reasonably~~
21 ~~expected to be incurred by the corporation in performing those~~
22 ~~contracts or providing service to utility customers. Paragraph (2)~~
23 ~~of subdivision (b) is not applicable to a corporation which does~~
24 ~~not classify its assets into current and fixed under generally~~
25 ~~accepted accounting principles.~~

26 (c) ~~The amount of any distribution payable in property shall,~~
27 ~~for the purposes of this chapter, be determined on the basis of the~~
28 ~~value at which the property is carried on the corporation’s financial~~
29 ~~statements in accordance with generally accepted accounting~~
30 ~~principles.~~

31 (2) *Immediately after the distribution, the value of the*
32 *corporation’s assets would equal or exceed the sum of its total*
33 *liabilities plus the preferential rights amount.*

34 (d)
35 (b) ~~For the purpose of applying this section paragraph (1) of~~
36 ~~subdivision (a) to a distribution by a corporation, “preferential~~
37 ~~dividends arrears amount” means the amount, if any, of cumulative~~
38 ~~dividends in arrears on all shares having a preference with respect~~
39 ~~to payment of dividends over the class or series to which the~~
40 ~~applicable distribution is being made, provided that if the articles~~

1 of incorporation provide that a distribution can be made without
2 regard to preferential dividends arrears amount, then the
3 preferential dividends arrears amount shall be zero. For the
4 purpose of applying paragraph (2) of subdivision (a) to a
5 distribution by a corporation, “preferential rights amount” means
6 the amount that would be needed if the corporation were to be
7 dissolved at the time of the distribution to satisfy the preferential
8 rights, including accrued but unpaid dividends, of other
9 shareholders upon dissolution that are superior to the rights of
10 the shareholders receiving the distribution, provided that if the
11 articles of incorporation provide that a distribution can be made
12 without regard to any preferential rights, then the preferential
13 rights amount shall be zero. In the case of a distribution of cash
14 or property in payment by the corporation in connection with the
15 purchase of its shares, (1) there shall be added to retained earnings
16 all amounts that had been previously deducted therefrom with
17 respect to obligations incurred in connection with the corporation’s
18 repurchase of its shares and reflected on the corporation’s balance
19 sheet, but not in excess of the principal of the obligations that
20 remain unpaid immediately prior to the distribution. ~~In addition,~~
21 ~~and~~ (2) there shall be deducted from liabilities all amounts that
22 had been previously added thereto with respect to the obligations
23 incurred in connection with the corporation’s repurchase of its
24 shares and reflected on the corporation’s balance sheet, but not in
25 excess of the principal of the obligations that will remain unpaid
26 after the distribution, provided that no addition to retained earnings
27 or deduction from liabilities under this subdivision shall occur on
28 account of any obligation that is a distribution to the corporation’s
29 shareholders (Section 166) at the time the obligation is incurred.
30 (c) The board of directors may base a determination that a
31 distribution is not prohibited under subdivision (a) or under Section
32 501 on any of the following:
33 (1) Financial statements prepared on the basis of accounting
34 practices and principles that are reasonable under the
35 circumstances.
36 (2) A fair valuation.
37 (3) Any other method that is reasonable under the
38 circumstances.
39 (d) The effect of a distribution under paragraphs (1) or (2) of
40 subdivision (a) is measured as of the date the distribution is

1 *authorized if the payment occurs within 120 days after the date of*
2 *authorization.*

3 *(e) (1) If terms of indebtedness provide that payment of principal*
4 *and interest is to be made only if, and to the extent that, payment*
5 *of a distribution to shareholders could then be made under this*
6 *section, indebtedness of a corporation, including indebtedness*
7 *issued as a distribution, is not a liability for purposes of*
8 *determinations made under paragraph (2) of subdivision (a).*

9 *(2) If indebtedness is issued as a distribution, each payment of*
10 *principal or interest on the indebtedness shall be treated as a*
11 *distribution, the effect of which is measured on the date the*
12 *payment of the indebtedness is actually made.*

13 *(e)*

14 *(f) This section does not apply to a corporation licensed as a*
15 *broker-dealer under Chapter 2 (commencing with Section 25210)*
16 *of Part 3 of Division 1 of Title 4, if immediately after giving effect*
17 *to any distribution the corporation is in compliance with the net*
18 *capital rules of the Commissioner of Corporations and the*
19 *Securities and Exchange Commission.*

20 SEC. 2. Section 502 of the Corporations Code is repealed.

21 ~~502. Neither a corporation nor any of its subsidiaries shall~~
22 ~~make any distribution to the corporation's shareholders (Section~~
23 ~~166) on any shares of its stock of any class or series that are junior~~
24 ~~to outstanding shares of any other class or series with respect to~~
25 ~~distribution of assets on liquidation if, after giving effect thereto,~~
26 ~~the excess of its assets (exclusive of goodwill, capitalized research~~
27 ~~and development expenses and deferred charges) over its liabilities~~
28 ~~(not including deferred taxes, deferred income and other deferred~~
29 ~~credits) would be less than the liquidation preference of all shares~~
30 ~~having a preference on liquidation over the class or series to which~~
31 ~~the distribution is made; provided, however, that for the purpose~~
32 ~~of applying this section to a distribution by a corporation of cash~~
33 ~~or property in payment by the corporation in connection with the~~
34 ~~purchase of its shares, there shall be deducted from liabilities all~~
35 ~~amounts that had been previously added thereto with respect to~~
36 ~~obligations incurred in connection with the corporation's~~
37 ~~repurchase of its shares and reflected on the corporation's balance~~
38 ~~sheet, but not in excess of the principal of the obligations that will~~
39 ~~remain unpaid after the distribution; provided, further, that no~~
40 ~~deduction from liabilities shall occur on account of any obligation~~

1 that is a distribution to the corporation's shareholders (Section
2 166) at the time the obligation is incurred.

3 SEC. 3. Section 503 of the Corporations Code is repealed.

4 503. ~~Neither a corporation nor any of its subsidiaries shall
5 make any distribution to the corporation's shareholders (Section
6 166) on any shares of its stock of any class or series that are junior
7 to outstanding shares of any other class or series with respect to
8 payment of dividends, and as to which senior class or series the
9 corporation has cumulative dividends in arrears, unless the amount
10 of the retained earnings of the corporation immediately prior
11 thereto equals or exceeds the amount of the proposed distribution
12 plus the aggregate amount of the cumulative dividends in arrears
13 on all shares having a preference with respect to payment of
14 dividends over the class or series to which the distribution is made;
15 provided, however, that for the purpose of applying this section
16 to a distribution by a corporation of cash or property in payment
17 by the corporation in connection with the purchase of its shares,
18 there shall be added to retained earnings all amounts that had been
19 previously deducted therefrom with respect to obligations incurred
20 in connection with the corporation's repurchase of its shares and
21 reflected on the corporation's balance sheet, but not in excess of
22 the principal of the obligations that remain unpaid immediately
23 prior to the distribution; provided, further, that no addition to
24 retained earnings shall occur on account of any obligation that is
25 a distribution to the corporation's shareholders (Section 166) at
26 the time the obligation is incurred.~~

27 SEC. 4. Section 503 is added to the Corporations Code, to read:

28 503. (a) The provisions of Sections 500 and 501 shall not apply
29 to a purchase or redemption of shares of a deceased shareholder
30 from the proceeds of insurance on the life of that shareholder in
31 excess of the total amount of all premiums paid by the corporation
32 for that insurance, in order to carry out the provisions of an
33 agreement between the corporation and that shareholder to purchase
34 or redeem those shares upon the death of the shareholder.

35 (b) The provisions of Sections 500 and 501 shall not apply to
36 the purchase or redemption of shares of a disabled shareholder
37 from the proceeds of disability insurance applicable to the disabled
38 shareholder in excess of the total amount of all premiums paid by
39 the corporation for the insurance, in order to carry out the
40 provisions of an agreement between the corporation and the

1 shareholder to purchase or redeem shares upon the disability of
2 the shareholder as defined within that policy. For the purposes of
3 this subdivision, “disability insurance” means an agreement of
4 indemnification against the insured’s loss of the ability to work
5 due to accident or illness.

6 SEC. 5. Section 506 of the Corporations Code is amended to
7 read:

8 506. (a) Any shareholder who receives any distribution
9 prohibited by this chapter with knowledge of facts indicating the
10 impropriety thereof is liable to the corporation for the benefit of
11 all of the creditors or shareholders entitled to institute an action
12 under subdivision (b) for the amount so received by the shareholder
13 with interest thereon at the legal rate on judgments until paid, but
14 not exceeding the liabilities of the corporation owed to
15 nonconsenting creditors at the time of the violation and the injury
16 suffered by nonconsenting shareholders, as the case may be. For
17 purposes of this chapter, in the event that any shareholder receives
18 ~~any distribution of the corporation’s property that is prohibited by~~
19 ~~this chapter,~~ *determining the value of any noncash property*
20 *received in a distribution described in the preceding sentence,* the
21 shareholder receiving that illegal distribution shall be liable to the
22 corporation for an amount equal to the fair market value of the
23 property at the time of the illegal distribution plus interest thereon
24 from the date of the distribution at the legal rate on judgments until
25 paid, together with all reasonably incurred costs of appraisal or
26 other valuation, if any, of that property, but not exceeding the
27 liabilities of the corporation owed to nonconsenting creditors at
28 the time of the violation and the injury suffered by nonconsenting
29 shareholders, as the case may be.

30 (b) Suit may be brought in the name of the corporation to enforce
31 the liability (1) to creditors arising under subdivision (a) for a
32 violation of Section 500 or 501 against any or all shareholders
33 liable by any one or more creditors of the corporation whose debts
34 or claims arose prior to the time of the distribution to shareholders
35 and who have not consented thereto, whether or not they have
36 reduced their claims to judgment, or (2) to shareholders arising
37 under subdivision (a) for a violation of ~~Section 502 or 503~~ 500
38 against any or all shareholders liable by ~~any~~ one or more holders
39 of ~~preferred~~ *shares having preferential rights with respect to*
40 *cumulative dividends in arrears, in the case of a violation of*

1 paragraph (1) of subdivision (a) of Section 500, or upon
2 dissolution, in the case of a violation of paragraph (2) of
3 subdivision (a) of Section 500, who have not consented to the
4 applicable distribution, without regard to the provisions in Section
5 800, in each case to the extent the applicable shares with
6 preferential rights were outstanding at the time of the distribution
7 ~~who have not consented thereto~~; provided that holders of shares
8 of preferential rights shall not have the right to bring suit in the
9 name of the corporation under this subdivision unless the
10 preferential dividends arrears amount, in the case of a violation
11 of paragraph (1) of subdivision (a) of Section 500, or the
12 preferential rights amount, in the case of a violation of paragraph
13 (2) of subdivision (a) of Section 500, was greater than zero, in
14 each case of those who have not consented to the applicable
15 distribution, without regard to the provisions of Section 800. A
16 cause of action with respect to an obligation to return a distribution
17 pursuant to this section shall be extinguished unless the action is
18 brought within four years after the date the distribution is made.

19 (c) Any shareholder sued under this section may implead all
20 other shareholders liable under this section and may compel
21 contribution, either in that action or in an independent action
22 against shareholders not joined in that action.

23 (d) Nothing contained in this section affects any liability which
24 any shareholder may have under Chapter 1 (commencing with
25 Section 3439) of Title 2 of Part 2 of Division 4 of the Civil Code.

26 SEC. 6. Section 507 of the Corporations Code is repealed.

27 ~~507. Each dividend other than one chargeable to retained~~
28 ~~earnings shall be identified in a notice to shareholders as being~~
29 ~~made from a source other than retained earnings, stating the~~
30 ~~accounting treatment thereof. The notice shall accompany the~~
31 ~~dividend or shall be given within three months after the end of the~~
32 ~~fiscal year in which the dividend is paid.~~

33 SEC. 7. Section 509 of the Corporations Code is amended to
34 read:

35 509. (a) A corporation may redeem any or all shares which
36 are redeemable at its option by (1) giving notice of redemption as
37 *provided in subdivisions (b) and (c) or as otherwise provided in*
38 *its articles of incorporation*, and (2) payment or deposit of the
39 redemption price of the shares as provided in its articles or deposit
40 of the redemption price pursuant to subdivision (d).

(b) Subject to any provisions in the articles with respect to the notice required for redemption of shares, the corporation may give notice of the redemption of any or all shares subject to redemption by causing a notice of redemption to be published in a newspaper of general circulation in the county in which the principal executive office of the corporation is located at least once a week for two successive weeks, in each instance on any day of the week, commencing not earlier than 60 nor later than 20 days before the date fixed for redemption. The notice of redemption shall set forth all of the following:

(1) The class or series of shares or part of any class or series of shares to be redeemed.

(2) The date fixed for redemption.

(3) The redemption price.

(4) If the shares are certificated securities, the place at which the shareholders may obtain payment of the redemption price upon surrender of their share certificates.

(c) If the corporation gives notice of redemption pursuant to subdivision (b), it shall also mail a copy of the notice of redemption to each holder of record of shares to be redeemed as of the date of mailing or record date fixed in accordance with Section 701, addressed to the holder at the address of such holder appearing on the books of the corporation or given by the holder to the corporation for the purpose of notice, or if no such address appears or is given at the place where the principal executive office of the corporation is located, not earlier than 60 nor later than 20 days before the date fixed for redemption. Failure to comply with this subdivision does not invalidate the redemption of the shares.

(d) If, on or prior to any date fixed for redemption of redeemable shares, the corporation deposits with any bank or trust company in this state as a trust fund, (1) a sum sufficient to redeem, on the date fixed for redemption thereof, the shares called for redemption, (2) in the case of the redemption of any uncertificated securities, an officer's certificate setting forth the holders thereof registered on the books of the corporation and the number of shares held by each, and (3) irrevocable instructions and authority to the bank or trust company to publish the notice of redemption thereof (or to complete publication if theretofore commenced) and to pay, on and after the date fixed for redemption or prior thereto, the redemption price of the shares to their respective holders upon the

1 surrender of their share certificates, in the case of certificated
2 securities, or the delivery of the officer's certificate in the case of
3 uncertificated securities, then from and after the date of the deposit
4 (although prior to the date fixed for redemption) the shares called
5 shall be redeemed and the dividends on those shares shall cease
6 to accrue after the date fixed for redemption. The deposit shall
7 constitute full payment of the shares to their holders and from and
8 after the date of the deposit the shares shall no longer be
9 outstanding and the holders thereof shall cease to be shareholders
10 with respect to the shares and shall have no rights with respect
11 thereto except the right to receive from the bank or trust company
12 payment of the redemption price of the shares without interest,
13 upon surrender of their certificates therefor, in the case of
14 certificated securities, and any right to convert the shares which
15 may exist and then continue for any period fixed by its terms.

16 In determining the holders of uncertificated securities, the bank
17 or trust company shall be entitled to rely on any officer's certificate
18 deposited with it in accordance with this subdivision.